Economic Update

HOUSE COMMITTEE ON THE BUDGET
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Growing Evidence of Economic Rebound

ECONOMIC RECOVERY UNDER WAY

Last November, the Business Cycle Dating Committee of the National Bureau of Economic Research [NBER] announced the economy was in a recession that had begun in March 2001. Significantly, the NBER said it was not clear until after the terrorist attacks of 11 September that the economic slowdown was severe enough to warrant the "recession" determination.

Yet despite the profound shock from the attacks and the aftermath, recent data indicate that the recession was the mildest on record, and likely is now over. On 7 March, Fed Chairman Greenspan said: "[E]vidence increasingly suggests that an economic expansion is already well under way."

Indeed, real GDP growth now is expected to have rebounded sharply in the 1st quarter of 2002 – largely as a result of business inventory swings and continued growth in personal consumption spending – which surprised nearly everyone. Around the turn of the year, analysts believed the economy had continued to contract in the final quarter of 2001, and that growth would return at a slow rate in early 2002. Instead, the U.S. economy posted a 1.7-percent rate of real GDP growth in the 4th quarter – just after the shock of the terrorist attacks – and has surged in early 2002. The Blue Chip "consensus" of private forecasters now expects real GDP growth at a 4.5-percent rate for the 1st quarter of this year.

As the table alongside shows, the April Blue Chip consensus now calls for much stronger growth in 2002 than either the Office of Management and Budget [OMB] or the Congressional Budget Office [CBO] assumed for their respective budget projections. For calendar year 2002, the Blue Chip projects real GDP growth at 2.6 percent, compared to the 0.7-percent rate assumed in the President's budget and in the House-passed budget resolution for fiscal year 2003 (H.Con.Res. 353).

Comparison of Key Economic Assumptions

	2002	2003
Real GDP Growth		
April Blue Chip	2.6	3.5
OMB Budget	0.7	3.8
CBO March	1.7	3.4
Nominal GDP Growth		
April Blue Chip	4.0	5.5
OMB Budget	2.8	5.6
CBO March	3.1	5.4
Unemployment Rate		
April Blue Chip	5.7	5.3
OMB Budget	5.9	5.5
CBO March	6.1	5.9

The current Blue Chip consensus also suggests higher *levels* of nominal and real GDP for 2002 and beyond. It is the level of nominal GDP – and the associated higher income levels for wages and salaries and corporate profits – that largely determine the levels of tax receipts in budget projections. Insufficient data exist at this time to make any definitive statements, but barring unforeseen events, the improved economic outlook should help boost the budget outlook, or help to offset any negative technicals or other costs.

SUCCESSFUL POLICIES

Clearly, some sectors of the economy – especially manufacturing and investment – experienced significant deterioration as the economy slowed last year. But if data for the recovery hold up, the 2001 recession overall will be the mildest on record, with only a small decline in real GDP and moderate adverse effects in labor markets.

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Credit for these results, and the subsequent rebound, lies mainly with the diversity and resilience of the economy itself. Still, quick and decisive actions by the President, the Congress, and the Federal Reserve provided significant help. The Fed cut interest rates aggressively throughout 2001. Congress worked with the President to pass, in June, the Economic Growth and Tax Relief Reconciliation Act of 2001 [EGTRRA] – including marginal income tax rate reductions and a tax rebate that quickly put money in the hands of consumers. Both sets of actions helped keep the economy growing.

After 11 September, the Federal Reserve continued to quickly reduce interest rates, lowering the Federal funds rate to the lowest level in 4 decades. In March, Congress passed, and the President signed, the Job Creation and Worker Assistance Act of 2002, which provides economic incentives and benefits precisely for the areas of remaining economic weakness: higher unemployment and lower investment. The bill's extension of unemployment insurance benefits will support the finances of the longer-term unemployed. Its provisions allowing accelerated depreciation for equipment and software will promote business investment spending – a critically important component for promoting a continuation of the era of higher labor productivity growth.

LABOR MARKETS MAY LAG A BIT

Despite the positive developments cited above, however, the March employment report showed an unemployment rate of 5.7 percent and an increase in payroll jobs of just 58,000. The latter figure is a relatively small gain in jobs – though it was the first increase in 8 months, and the largest since the recession began.

The pattern may continue in the near term. A lesson from history, especially from the 1990-1992 period, is that the recovery will feed through to yield benefits in labor markets – but sometimes it just takes time. In the case of an initially slower rebound, the longer-run benefits can be significant – with higher real wage growth and even lower unemployment rates than could have been expected.

BENEFITS FROM PRODUCTIVITY GROWTH

Strong productivity growth has been a hallmark of the U.S. economy since the mid-1990s. With the advent of fiscal discipline – especially the outlook for spending discipline that emerged in 1995 with congressional plans to restrain spending and balance the Federal budget – the outlook for enhanced long-run growth prospects improved markedly. Reduced risk and uncertainty promoted a pro-investment environment for business and financial markets that led to stronger investment spending, and a significant improvement in trend productivity growth. Continued spending discipline, as envisaged in the House-passed budget, will promote the continuation of a pro-growth policy environment.

Labor productivity growth in the nonfarm business sector has been rising at about a 2½-percent trend rate since 1995, compared to the trend rate of less than 1½ percent that occurred over the 1973-1995 period. Recent data indicate that the higher rate of trend productivity growth appears to have continued through the recession and into the early expansion period now at hand.

Although a surge in labor productivity growth initially can be associated with a lagged recovery in labor markets at this stage of the economic recovery – with output growing prior to a pickup in employment – the strong productivity growth ultimately will yield further benefits for American workers. The table below shows the close relationship between labor productivity growth and growth in real hourly compensation for workers in business cycle periods of the past 30 years. Labor productivity growth averaged only about 1.4 percent per year from the cycle peak in the 4th quarter of 1973 to the peak in the 3d quarter of 1990. Over the same period, real hourly compensation – wages, salaries, and benefits – rose by 1.2 percent per year on average. In comparison, productivity growth during the 1990s' expansion averaged 2.2 percent from peak to peak, and growth in real hourly compensation increased to a 2.0-percent annual rate.

Labor Productivity and Real Compensation

	1973.4-1990.3	1990.3-2001.1
	(percent change, annual rate)	
Labor Productivity	1.4	2.2
Real Compensation/Hour	1.2	2.0

Nonfarm business sector data, BLS. Real compensation measure determined using chain-weighted GDP price index.

The lesson is that even if the recovery in labor markets were to initially lag the rebound in GDP growth this year, the expectation should be that strong productivity growth will promote a return to solid economic expansion with higher employment, rising real wages for workers, and higher standards of living for American families.